Office of Chief Counsel
Internal Revenue Service

# memorandum

CC:NER:NJD:NEW:TL-N-1946-99
RABaxer

date: MAY 5 1999

to: Chief, Examination Division, New Jersey District E:1509

from: District Counsel, New Jersey District, Newark

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subject: [redacted]
Technical Service Fees
Tax Periods: [redacted] - [redacted]

This memorandum has been prepared in response to your request for assistance and guidance from our office with respect to the proposed examination of the above taxpayer. The memorandum is based upon the facts outlined below. If the factual statement is incorrect, please notify this office so that we may determine the effect, if any, on the advice rendered.

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DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

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ISSUE

Can a summons be issued to require the taxpayer to provide information with respect to allocations of services charged to foreign affiliates under Treas. Reg. § 1.482-2(b)(3).

FACTS

The facts as we understand them are as follows:

[redacted] ([redacted]) is currently under examination for the [redacted]-[redacted] tax years.

The International Examiner assigned to this case has performed an analysis of Forms 5471, Schedule M transactions for the following categories; Compensation Received, Commission Received, Rents Received, Compensation Paid, Commissions Paid and Rents Paid.

The IDRs 71 and 73 prepared by the International Agent requested the following specific information with respect to the above categories.

1. To whom the payments were made and from whom the payments were received.
2. Percentage of Net Sales used to compute the fees for CFCs listed.
3. The amount of Net Sales used to compute the fees of the CFCs listed.
4. All agreements, licenses, contracts, etc. that pertain to the payments paid and received by the CFCs.
5. All agreements, licenses, contracts, etc. with unrelated entities that are similar to above.
6. A schedule of costs incurred by type and amount for years under examination for each of the above agreements.
7. An explanation of the costs, services, advice, assistance, management, etc., provided by the U.S. parent to the CFCs.
8. Copies of any internal and external studies in regard to the above transactions as required by the IRS Regulations.

In response, the taxpayer submitted a position paper dated [redacted] entitled [redacted]-[redacted] Federal Income Tax Audit: IDRs 71 & 73: Technical Service Fees.

The position of the taxpayer is summarized as follows:

1. [redacted] ([redacted]) renders the services to foreign affiliates under technical service fee (TSF) agreements.

2. Reg. 1.482-2(b)(3) provides that the arms-length charge for the services provided by one member of a controlled group for another member shall be equal to the costs or deductions incurred with respect to such services unless the service is an integral part of either member's business activity.

3. The services are not an integral part of either [redacted]s or the CFCs business activities as described in Reg 1.482-2(b)(7), thus the arms-length charge is equal to cost. (This was a summary conclusion on the part of the taxpayer with no reasoning as to how

they arrived a this conclusion.)

4. As a general rule, [redacted]s costs incurred in providing the services are incurred by its Overseas Division. The total costs incurred have been provided to the examiners.

5. The mechanism utilized to recover the total costs varies in order to comply with local laws and regulations.

6. [redacted]s position is that the propriety of the fees charged by [redacted] should be determined based upon the total cost of services provided; i.e., if total service fees equal the total cost of services rendered, no adjustment is required. They cite to Kenco Restaurants, Inc. v. Commissioner, T.C. Memo. 1998-342 wherein the total of fees went unchallenged by the IRS, but a redistribution was made of the total between members of the affiliated group.

7. Since [redacted]s CFCs are not subject to U.S. tax, there is no reason to challenge the allocations as there would be no impact on [redacted]s or [redacted]s taxable income.

As a result of the position paper, the taxpayer sees no reason to comply with IDRs 71 and 73.

You have provided us with several sample TSF contracts to review. They seem to fall into two categories. They are for technical services alone, or they are for a combination of use of intangibles and technical service fees. The payment provisions appear to be a fee based upon a percentage of sales and range from [redacted]% to [redacted]%. In the combination contracts, sometimes the portion of payment for the technical services is broken out other times there is no allocation as to what portion of the total payment is for royalties and what portion is for service fees. There does not appear to be any consistent method being used by the taxpayer.

## LAW

Treas. Reg. § 1.482-2(b)(1) provides that where one member of a group of controlled entities performs marketing, management, administrative, technical, or other services for the benefit of, or on behalf of another member of the group without charge, or at a charge which is not equal to an arm's length charge, the district director may make appropriate allocations to reflect an arm's length charge for such services.

Treas. Reg. § 1.482-2(b)(3) defines the arm's length charge as meaning, generally, the amount that would have been charged to an unrelated entity for the same or similar services under similar circumstances. However, except in the case of services which are an integral part of the business activity of either the member rendering the services or the member receiving the benefit of the

services, the arm's length charge shall be deemed to be equal to the costs or deductions incurred with respect to such services by the member or members rendering such services unless the taxpayer establishes a more appropriate charge.

Treas. Reg. § 1.482-2(b)(3) also provides that where costs or deductions are a factor in applying the provisions of this paragraph adequate books and records must be maintained by the taxpayer to permit verification of such costs or deductions by the Internal Revenue Service.

The costs or deductions to be taken into account are set forth in Treas. Reg. § 1.482-2(b)(4) and (5). It is necessary to take into account on some reasonable basis all the costs or deductions which are directly or indirectly related to the services performed. Examples of direct and indirect expenses are contained in these regulation sections.

Where the arm's length charge is determined by reference to costs or deductions, and a member has allocated and apportioned them in a consistent manner employing a method of allocation which is reasonable and in keeping with sound accounting practices, such method will not be disturbed. Treas. Reg. § 1.482-2(b)(6)(i).

Under Treas. Reg. § 1.482-2(b)(7) an arm's length charge shall not be deemed equal to costs or deductions with respect to services that are an integral part of the business activity of either the member rendering the services or the member receiving the benefit of the services. Examples of situations in which services are considered an integral part of the business activity of a member of a controlled group are set forth in Treas. Reg. §§ 1.482-(b)(7)(i) through (b)(7)(iv).

I.R.C. § 7206(a) permits the Service to: 1) examine any books, papers, records or other data; summon a taxpayer or any other person, requiring them to appear, produce books, papers, records, or other data and give testimony under oath; and (3) take testimony under oath.

Under the standards set forth in U.S. v. Powell, 379 U.S. 48 (1964), unless the taxpayer can assert a valid privilege or limitation, a summons is generally enforceable if: (1) there is a legitimate purpose for the Service's examination; (2) the information summoned may be relevant to that purpose; (3) the information is not already in the possession of the Service; and (4) the Service has complied with the administrative steps required by the Code and the regulations.

## DISCUSSION

In our opinion the taxpayer's reliance on Kenco Restaurants,

Inc. v. Commissioner, supra is misplaced. In that case there was no question as to the total charges that comprised the services rendered to the members of the group. The issue was the proper allocation of the total amount of expenses between the members of the group.

The taxpayer has given you figures paid from the CFCs to [redacted] that include service fees and royalties from intangibles. Their reasoning is that since the total payments are in excess of the service fees incurred by [redacted], they have been fully reimbursed for the service fees by the CFCs.

In our meeting of April 6th, you indicated that you have not accepted the figures given to you by the taxpayer as representing the total expenses charged to the CFCs for services. In fact, you had requested the information in IDRs 71 and 73 for the purpose of determining the fees being charged for services.

The schedule provided to you by the taxpayer makes reference to "Direct" costs incurred by [redacted] for the benefit of the CFCs. You do not know at this time if numbers given to you include an apportionment of indirect costs as set forth in Treas. Reg. § 1.482-2(b)(4)(iii). You have indicated that you will be pursuing this issue with the taxpayer.

The allocations made in Kenco were done from the top down, i.e. determine the total costs incurred by the renderer and allocate down to the recipients. This does not appear to be the case with [redacted].

In your case, there does not appear to be any specific determination of the service fees that are applicable to each individual CFC. The method of reimbursement for the service fees confirms this fact. Instead of an actual reimbursement for services rendered, which would require a determination of actual services performed, the reimbursement is tied into a percentage return on net sales. It is inconceivable that such a reimbursement method would equal the actual costs of services provided to the individual CFCs.

This method of reimbursement (percentage of net sales) is especially troubling where the contracts provide that the payments are for both service fees and royalties for intangibles. Without knowing the actual costs of the service fees, it becomes impossible to determine if the royalty payment is an arm's length charge. As an example, take two CFCs, A and B. Both CFCs have contracts that cover intangibles and technical service fees and provide for a single reimbursement of 3% of net sales. Assume that the CFCs are similarly situated and should be paying the same royalty on the intangibles. If the technical services rendered to A cost $1,000,000 and the technical services to B cost $3,000,000, then you have the following inconsistent situation. The intangible

royalties from A are [3% of net sales - $1,000,000] and for B the royalties are [3% of net sales - $3,000,000]. The natural conclusion is that either A is overpaying the intangible royalty or B is underpaying the intangible royalty. To insure that a consistent arm's length intangible royalty is being charged, the reimbursement contacts for A and B should require [X% of net sales plus actual costs of services rendered].

A similar situation existed in Sundstrand v. Commissioner, 96 T.C. 226 (1991) "Sundstrand I". In that case, the agreement between the related members required a 2% fee based upon net selling price of the product for the rights acquired and any technical assistance rendered. The Court found that the 2% royalty fee was inadequate compensation for the intangible property transferred and used. As such, they indicated that as an effect of that determination, the technical assistance rendered by the taxpayer went uncompensated. The Court determined the costs of the technical services rendered in the years at issue and made a section 482 adjustment in that amount.

In a subsequent case involving the same taxpayer, Sundstrand v. Commissioner, T.C. Memo. 1992-86, 63 TCM 2043 "Sundstrand II", there were a number of pertinent observations and statements made by the Court.

First, the Service was criticized by the Court for failing to use its administrative summons power to seek information that the taxpayer had refused to supply to the revenue agents with respect to a section 482 issue.

Second, in commenting upon the service fees issue decided in the prior Sundstrand litigation the Court stated:

> In Sundstrand I we held that in an arm's-length transaction, petitioner would have demanded to be compensated separately for the technical assistance it gave SunPac.

Finally, in Sundstrand I the Service first raised on brief that the technical services rendered were valuable services that had to be compensated for at an arm's length charge. The Court refused to consider the issue and used costs as the measure for the section 482 adjustment in that case. In Sundstrand II the valuable technical services issue was raised in the notice of deficiency. In response to an argument in Sundstrand II by the taxpayer that costs were the controlling factor the Court stated:

> In the instant case respondent raised the services theory in the notice of deficiency. Nonetheless, petitioner contends that our holding on the services theory in Sundstrand I is controlling here and that any section 482 adjustment for services must be limited to the difference

between actual costs rendered and the 3-percent technical assistance fee SunPac paid to petitioner pursuant to Amendment No. 11 to the SunPac Licence. Respondent argues, on the other hand, that the value of the services rendered in any year must be determined on the basis of the nature and extent of the services actually performed in that year. We agree with respondent.

You have also expressed a concern that some of the technical services being rendered to the CFCs may be considered an integral part of the business of the taxpayer under Treas. Reg. § 1.482-2(b)(7)(iii). This regulation section states that services will be considered an integral part of the business activity where the renderer is peculiarly capable of rendering the services. To make this determination you have indicated that you would need to see a breakdown by category of the services being performed on behalf of the CFCs.

RESPONSE TO YOUR SPECIFIC QUESTION

Based upon the above observations, you have a legitimate reason to review the costs of technical services fees on a CFC by CFC basis and on a category by category basis. You may request this information from the taxpayer and if they refuse to provide the information the use of a summons would be appropriate to secure the information.

If you have any questions or need further information, please contact Robert A. Baxer at (973) 645-2598.

PATRICK E. WHELAN
Assistant District Counsel

NOTED:

MATTHEW MAGNONE
District Counsel

cc: Richard Laracy - Examination Group 1509
Charles Chiapperino - Examination Group 1114